RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year – $185 Annually
Registered with the Securities and Exchange Commission

December 16, 1981 **LETTER 824**

Dec. 4, DJIA 892.69; PTI 1447; A-D Ratio –21.85
Dec.11, DJIA 886.42; PTI 1435; A-D Ratio –22.61

THE PICTURE: So far, we are told, it's a case of deja vu. The recession deepens and the headlines blacken. Interest rates "appear" to have topped out. Money instruments rally and the stock market (taking heart from declining interest rates) climbs. Analysts develop a consensus that "the market has now discounted the worst and that the rally reflects better times ahead in mid to late-1982."

So I ask myself, is this just a repeat of a dozen other market declines and recessions? And I answer, maybe, but there's a fly in the ointment, and that fly is described in the Front Page Comment. The question: how do you handle a 42% jump in a national debt that is already over one trillion dollars? Answer: you borrow all you can and you let the Fed buy the rest. The first process is called "crowding out" in the bond market. The second process is called "monetization." Both precesses are disruptive to the money markets.

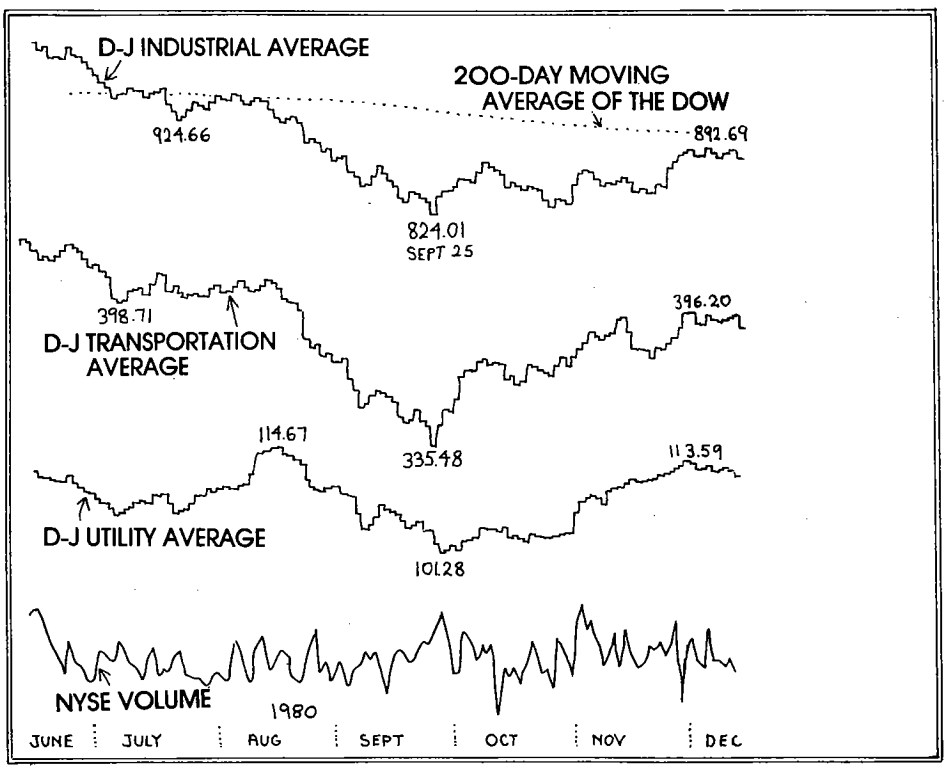
President Reagan (probably correctly) sees us as being in a life-and-death struggle with Russia (with Russia wanting to *control* the natural resources of the globe). It's obvious that Reagan wants a giant military build-up, and I'm reasonably certain that Congress is going to give it to him. The only question (with sky-rocketing costs of weapon systems) is how far above the budget the military costs are going to climb? All in all, what I see ahead is a FIRST in American history – a huge military build-up plus a massive tax cut, all in the face of a recession and a trillion dollar national debt. Does that sound like the perfect prescription for disaster? I'm afraid it does to me, but who can know for certain?

FRONT PAGE COMMENT: Like "the monster from the deep," the projections of the Federal deficits are emerging. The latest Administration estimate of deficits is $109 billion for the current fiscal (1982) year, $162 billion for 1983 and $152 billion for 1984. The current 1982 deficit figure is almost triple the original Administration estimate of $42 billion. The latest series adds up to $423 billion in deficits over the coming three years. Theses projections would boost the current incredible $1 trillion national debt 42% in three years! In case you didn't realize it, the US deficits are going WILD! The financing of the US Government is totally OUT-OF-CONTROL.

Worse still, I predict that tax receipts to the Treasury (due to the recession) are going to plunge during 1982. This together with rising costs due to the recession and to rising military and entitlement costs) could push the 1982 deficit far above the newly projected $109 billion. The year 1982 is shaping up as a shocker.

As for interest rates, watch the longer-term bond market. These markets cannot be manipulated by the Fed or anyone else. So far, long-term Treasury bonds are down from a peak of 15.25% to around 13½%, a total drop of less than 2%. That's hardly going to turn the building industry around.

With this kind of unbelievable financial puzzle staring us in the face, the obvious thing would be to see gold heading into the wild blue yonder. Yet gold languishes below 425. Why? A few possible answers come to mind. One is that gold is just not ready to move yet. A second answer (and I wrote about this on numerous occasions last year) is that the FORCES OF INFLATION AND DEFLATION ARE NOW MEETING HEAD ON. And gold is confused.



The forces of inflation are easy to comprehend. When the giant deficits come in, the Fed will monetize a large portion of that debt. This will be highly inflationary, and a new blizzard of dollars will envelop the land. But the forces of deflation are more difficult to understand (or maybe nobody wants to look at them). As tens of billions of dollars in new Government financing hits the markets (to say nothing of private financing needs), the money markets will swoon. Long-term interest rates will surge to new record highs, and in the face of an acute scarcity of funds, the economic slump will extend and intensify. Prices will buckle and deflation will hit a large part of the nation (all except the military, which will be relatively immune). On top of this, the Government will be in a frenzy to collect all the money it can. This will mean taxes, taxes and more taxes (watch for a value-added-tax of 10% on all goods across the board).

What do I see ahead for the market in view of the foregoing? I see tough times. I see stop-and-start markets, false breakouts, disappointing and aborted trends. For those advisory services who thrive on "brilliant calls," I see hard times. But for investors who are patient and stable, I see nothing ahead that cannot be handled successfully.

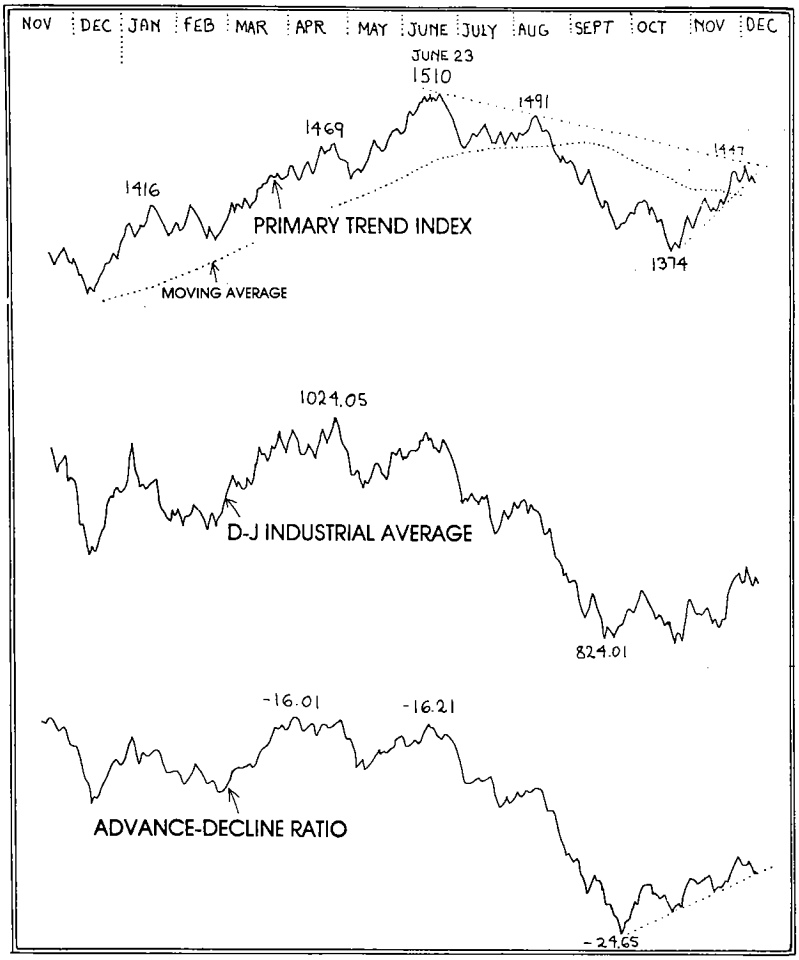
THE MARKET: In the last Letter I indicated that traders were entitled to follow the PTI, but I also said that I had many reservations about this market. I want to list my main reservations (doubts) now.

(1) The Dow Theory proclaimed a primary bear market in July. That bear signal has not been rescinded or reversed.

(2) The Dow dropped 200 points between its April high of 1024.05 and its September low of 824.01. Every market movement is entitled to a 1/3 to 2/3's correction. Yet these corrections in no way reverse the primary trend. A 1/3 correction of the September-April drop would take the Dow back to 891. A 2/3 correction would take the Dow back to 957. So far, all the Dow has done is correct 1/3 of the September-April losses.

(3) What the market does at the halfway level (50% level) of a preceding move is usually important. The 50% level of the September-April Dow decline is 924. So far the Dow has failed to recoup 50% of its losses. This is a negative.

(4) The advance-decline ratio has failed to keep up with the Dow on the rally from the September low. A sub-standard A-D performance constitutes a negative.



(5) Daily new highs have been surprisingly low on the rally. My 5-day moving average of new highs hit a peak of 50 on November 16. The 5-day moving average now stands at 16, one-third the November 16 total.

(6) The bull segment of the 233-day cycle is due to peak about the middle of December (about now). Thus, the market is now moving into the area of the bear segment of the cycle. The bear segment should carry into late-March. This constitutes a 3-month negative for the market. The bull segment of this cycle (July to December) was very weak, and the Dow ended the bull cycle at a lower level than when the cycle started. This has only occurred once before in the last 5 years (it happened in 1977).

(7) Finally, a rather curious situation. The D-J Utility Average (often a bellwether) hit a high of 114.67 in August. Despite a considerable drop in interest rates (and the Utilities are very sensitive to interest rates) the Utility Average has not been able to better its August high. This is another negative.

* *

Turning to the page 1 chart of the Averages, we see that the Industrial Average marched to 892.69 on December 4. This move constituted an exact one-third recovery of the 200 point July-September decline. The Transports rallied to 396.20 on December 1. This was a 75% recovery of the Transport losses. Both recovery rallies were "normal" in that they simply recouped adequate portions of the 200-point bear market decline. The Utilities, meanwhile, rose to 113.59 on November 30. This was still short of the August high of 114.67.

The 200 day moving average of the Dow now stands at 909, and it would be a technical plus if Industrials could better the MA and hold persistently above it. So far that has *not* occurred.

THE PRIMARY TREND INDEX: For the benefit of new subscribers, I will again describe the PTI. This is an amalgum of eight critical averages and indicators, computed each and every trading day. The result is an indicator that has been of great help in determining the underlying trend of the market. I don't use the PTI alone, as in a vacuum, but I do use the PTI in conjunction with Dow Theory and with many other indicators of market strength (or weakness).

The beauty of the PTI must be understood, however. The beauty of this indicator is that it is based strictly on MARKET ACTION. Thus, you can say that bank credit is too stringent and therefore the market "should" be going down. You can say that auto and home sales are increasing and therefore the market "ought" to be going up. But the PTI cuts through all that kind of economic malarkey and tells us what is *actually happening* in the market – not what should be happening.

Fifteen years ago when I first began my search for a market instrument, I knew I was looking for a device that would not be fooled by surface market action, economic statistics, subjective sentiment measures or Wall Street rumors. I knew as well as anyone else that the Dow can be doing one thing while most of the market is doing something else. It was the hidden tide of the market that I wanted to gauge, the hidden sub-surface primary trend of the market. The PTI seems to provide the answer.

"But," you ask, "isn't the A-D ratio on the NYSE just as good as the PTI?" And my answer is that the PTI measures not only the price action but the underlying build-up or deterioration in market strength. That is the advantage it has over the A-D ratio.

As I've said many times before, any persistent rise in the PTI will, in time, be accompanied by a rise in the general market. Conversely, any persistent decline in the PTI will be accompanied in due time by a decline in general stock prices.

The PTI, however, is not the perfect market indicator. The reason it is not perfect is that the PTI will not tell you *how long* a movement will last. Nor will it make money for you in a flat or trendless market. But that's as it should be since no market device has ever been invented that is capable of predicting the length of a move. Nor has anyone ever figured out a sure way of conjuring up stock profits in a trendless market.

The history of the PTI (happily) suggests that the PTI does tend to move in recognizable and often extended trends – while producing a minimum of whip-saws. And the beauty of the PTI is that one can sit back and patiently await the verdict of the PTI in the knowledge that when a market trend does appear, the PTI will point the way.

Turning to the PTI chart on page 2, note that the PTI recorded a low of 1374 on October 26. Since then it has moved up on a trendline basis, hitting a recent high of 1447 on December 4. As this is written, the PTI is above its 21-day moving average. But it is also just below the main bearish trendline, a trendline that extends from the 1510 high of June 23. (See Late Notes on page 6 for final PTI comments).

At the bottom of the chart we see the advance-decline ratio for the NYSE. Note the A-D is now resting on its rising trendline and any weakness from here will serve to rupture that trendline. At this point, all that can be said is that the A-D rise has been rather feeble. This is particularly curious in view of the fact that 1/3 of all NYSE issues are interest-rate sensitive, and interest rates have been coming down over the past few months.

The road ahead is not clear, and problems (both fundamental and technical) are still clouding the scene. So I continue to advise holding T-bills.

INTEREST RATES: I've been working for a couple of years on a technical system that will provide useful signals for important trend changes in interest rates. After countless experiments and tests, I believe I've hit on a system that is both accurate and simple. It entails only two indicators, but the two indicators MUST be used together. The two indicators are (1) a 13-day moving average of the yields on 91-day Treasury bills; (2) a 13-day momentum index (rate of change index) of (1).

I include a chart below of these two indicators, a chart taking the two back to October, 1980. Note that the rate of change (ROC) indicator turned down in December, 1980. In early February, 1981 the moving average of the yields confirmed by breaking below its rising trendline. This was the signal for a decline in interest rates.

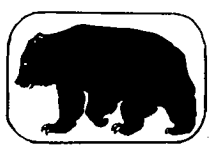
Again, momentum reached a peak in May, 1980. In September the moving average of T-bill yields broke its rising trendline, and this again was the signal for a decline in interest rates.

To bring this study to the present . . . note that T-bill momentum has now broken above its declining trendline – thereby reversing a 7-month downtrend. The moving average of yields has turned up but it has not yet reversed its declining trendline, I expect interest rates to be pushing UP strongly again (it's ironic that this is occurring while the Fed is attempting to bring ease into the system!).

Note: when the moving average of yields breaks its declining trendline, I expect interest rates to push strongly higher. This should exert a discouraging and bearish influence on both stocks and the economy. I will report the reversal to the upside in rates when it occurs.

As far as bonds are concerned, the chart on page 4 of the Treasury 7 5/8 of 2002 shows that the bond rallied up to the upper channel line, and over the past few weeks has dropped back

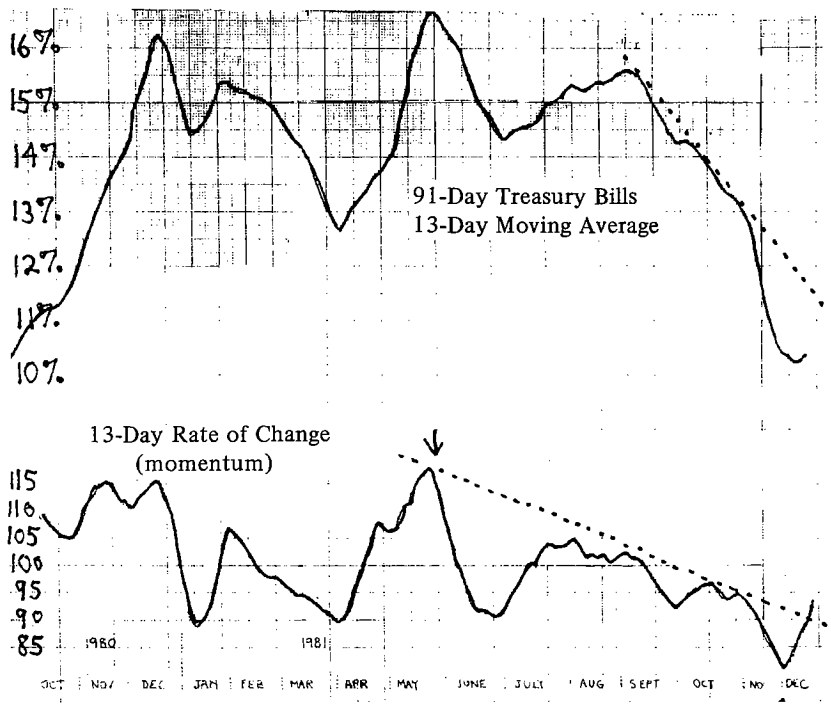
INVESTMENT POLICY:

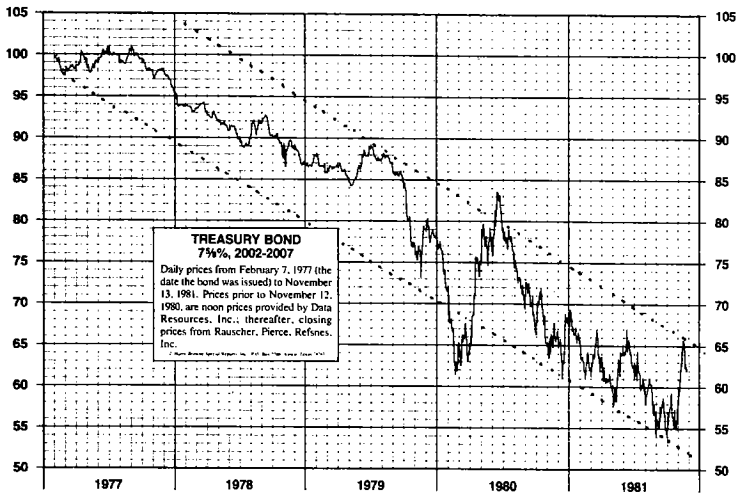


The bear still inhabits this box, and as long as he does I'll hold to the position I've held since the July Dow Theory bear signal. That position was and is . . . 91-day Treasury bills. I warned subscribers in July that collecting interest on T-bills is BORING. But I also told you that we're in this business to make money, not to be entertained.

I read maybe 50 different advisory publications each week, and of late I think I've digested every idea, theory and prediction under the sun. However, if you had simply followed my T-bill advice ("buy 'em and roll them over when they come due") I would guess that you're well ahead of the game. Certainly, you're ahead of most of your stock-trading friends (to say nothing of those who trade commodities, precious metals and what have you).

My own approximate return on T-bills this year is 12% (and happily, there is no state tax on T-bills). And I'd venture to say that most investors and traders have not matched 12% in 1981.





to the middle of the channel again, hardly the bull market that so many have heralded). Corporate bonds have not done nearly as well as Treasuries, and the municipal bond market remains a disaster (bond chart courtesy *Harry Browne Special Report,* PO Box 5586 Austin, TX 78763).

Question: Russell, how is it that you didn't give a buy signal for bonds in September when according to this chart, you got your signal for lower interest rates?

Answer: First, I only had a year of this study, and I wasn't that convinced that it would work. I'm a lot more convinced now! Second, I didn't expect the decline in interest rates to carry as far as it did, but obviously I was wrong.

Question: What do you see for a low on interest rates?

Answer: My chart strongly suggests that we have PASSED the bottom for T-bill yields. It is well to note that the bottom yield in 1981 was 10%, and this is a full 4% higher than the last bottom in 1980 (during the last recession the T-bill rate dropped to 6%). The implication is that the next peak on T-bill yields could easily be an all-time record high.

Question: Russell, what are the implications of this study for the money market?

Answer: The long-term build-up of the military plus rising Government needs for entitlement programs will be long-term bearish for bonds. Once the military build-up hits full force (starting around late-1984 to 1985) the pressure for money will be fierce.

Question: What about the implications for stocks?

Answer: I've thought long and hard about the picture, and I believe there will have to be a good deal of monetization of the deficits as the Government embarks on its military build-up. This will be inflationary, but not good for most stocks. It will be a problem picking stocks that are winners in an environment of declining civilian spending and rising Government spending. My bet is that during the coming period the markets will move in erratic trading ranges with a bias to the downside.

Question: Russell, what else do you see?

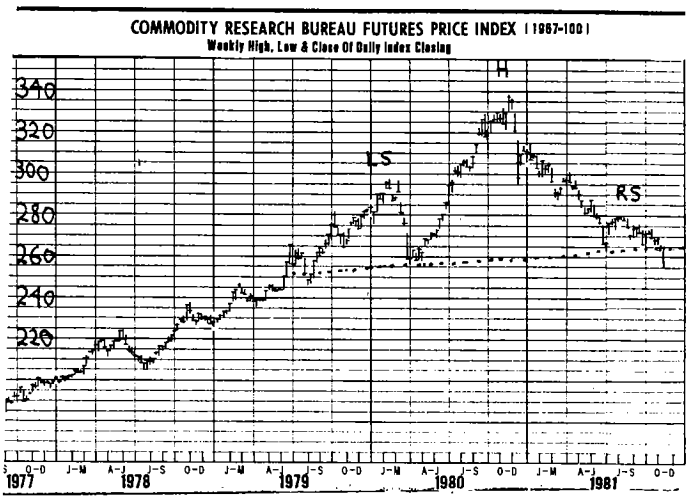
Answer: The big picture for the average American is that we are now moving into an era of *declining standards of living.* The "good times" will be gradually squeezed off as the all-out need for the military places constant pressure on the entire civilian economy. The most difficult part of it is that we may face inflation in the monetary area (dollars will be worth less) while we are facing deflation or at least hard times in the civilian area (wages squeezed in the face of international competition, plus a continuation of the recession in housing and autos with perhaps lower wages in many industries in the face of Japanese and Asiatic competition).

Question: What about gold in this picture?

Answer: My feeling is that the very long-term picture for gold is bullish – it's only a matter of timing. No one on this green planet knows whether the recent low of 392 was THE low or whether perhaps a double bottom (around 392 to 400) or even a final low will be seen during 1982. But with the needs of the Federal Government looming ever larger, the fundamentals for gold are brightening.

Question: What about commodities?

Answer: I include an up-dated chart of the widely-watched CRB Futures Index. Sad to say, this is an ominous and bearish chart. The Index is in a head-and-shoulders top pattern, and the support at 260 has just been broken. This could easily mean a fresh new smash in commodities with the index coming down to test the 200 area. With farmers now squeezed and in need of cash, the prospect of their products coming down (along with the metals, meats, etc.) is hardly encouraging. The Mid-West will be particularly hard hit with both farm products and autos in a depression.



UP-DATE: Many older subscribers may remember the study I published a few years ago, a study based on Professor Merklein's statistics that showed that by 1983-84 the cost of Government would consume all available funds within the US. Well, it hasn't come to that yet, but we are moving mighty close.

On page 5 is a most interesting up-date, based on data put out by Irwin Kellner of *Manufacturers Hanover.* The accompanying table includes three columns of figures. The first column shows *total* savings in the US. This includes gross private savings (both corporate and household) plus state and government surpluses. In 1981 total savings from all sources will be about $196 billion.

The second column includes all Federal and Federally-related borrowing, which includes direct borrowing by the Treasury. This is the deficit figure you usually read about. On top of this you have the so-called "off-budget" expenses. These are the hidden expenses that are incurred by the various Federal Agencies. These off-budget expenses, although hidden, do appear at the end-of-the-year as part of the Federal deficits. Column 2 also includes guaranteed Government loans, which this year were $51.3 billion!

The third column is the crux of the story. This column shows the total Federal and Federal-related borrowing as a PERCENTAGE

FEDERAL AND FEDERAL-RELATED BORROWINGS VS. TOTAL SAVINGS

Year	(1) Net National Savings* (Billions of Dollars)	(2) Federal and Federal-Related Borrowings** (Billions of Dollars)	Federal and Federal-Related Borrowings As A Percent Of Total Savings
1960	29.0	5.6	19.3
1961	31.3	6.1	19.5
1962	38.6	15.0	38.9
1963	38.3	12.0	31.3
1964	47.6	9.2	19.3
1965	58.2	10.5	18.0
1966	65.4	9.0	13.8
1967	70.4	1.0	1.4
1968	69.4	31.3	45.1
1969	64.8	11.1	17.1
1970	70.1	17.9	25.5
1971	87.8	33.4	38.0
1972	102.1	39.9	39.1
1973	118.1	47.6	40.3
1974	100.4	24.4	24.3
1975	110.6	64.9	58.7
1976	130.8	98.2	75.1
1977	168.3	79.5	47.2
1978	177.0	94.4	53.3
1979	174.8	81.6	46.7
1980	169.9	124.3	73.2
1981	196.0	154.5	78.8

of total savings (column 1). Running down column 3 we note that the percentage has increased from a low 19% in 1960 to 25.5% in 1970 to a staggering 78.8% in 1981. In other words, this year total Federal borrowing will capture roughly 8 out of every 10 dollars of savings!

What these statistics are telling us is that year after year the US Government preempts a greater and greater portion of the nation's savings. Obviously, *this cannot go on.* Or if it does, in a matter of a few years the Government will literally siphon off all available funds, leaving private industry out in the cold and unable to raise the capital needed for research, development and expansion.

This is bad enough but the thing that has me wondering is the coming massive build-up in the military. This giant build-up will accelerate the Government's need for more and more dollars. Where will the money come from? My only conclusion is this. The Russians have *sacrificed their civilian economy* in order to build their mammoth military machine. Can the US catch up to the Russians, can we build a huge military machine – and at the same time run a civilian economy at anything resembling prosperous levels? Are we that much smarter (better) than the Russians?

So at this late stage of the game, with our Government already sucking up 78 out of every 100 dollars in savings, my opinion is that the US must either (1) sacrifice a good deal of its civilian economy in the interests of building up a military machine capable of neutralizing the Russian military colossus, or (2) give up on neutralizing Russia, and face the possibility of total Russian world domination, domination stemming from Russian military superiority. From the looks of things and judging from what I see of President Reagan and Congress, the military build-up is already in place and the civilian economy is fated to face a massive and extended squeeze.

NOTES & QUOTES: I thought this piece (from *Parade*) was interesting. It's all part of a new Government deception. Stage one: let the oil companies raise their product price to the free market level – then hit them with a "windfall tax." Stage two: deregulate gas – then hit the gas companies with a windfall tax. Obviously, the consumer does the paying and the Government gets the windfall in the end. And the irony, the bitter irony, is that the voters still think they are getting something for nothing from their Government!

There is a further irony in the oil situation. Because Americans have been using less oil, with a consequent drop in prices charged by OPEC, the oil companies—which handle all imports (except for the Strategic Petroleum Reserve)—are earning less. They therefore pay less in "windfall profits tax," which may prove damaging to the government's budgetary planning. When OPEC prices rise, most of the profit increase goes to the U.S. Treasury in taxes. Thus is created a situation in which, for budget reasons, the Administration has a vested interest in imported oil being more expensive. It has been calculated that for every dollar drop in OPEC prices, the U.S. government loses $1.4 billion.

Meanwhile, the American oil consumer—squeezed between the OPEC crisis and the government's way of managing the energy problem—may soon again be feeling the pinch.

* * *

A "windfall profits" tax on natural-gas earnings is on top of Reagan's list of possible new revenue raisers. Administration experts predict that such a levy, linked to the speeded-up decontrol of gas prices, would bring in 20 billion to 30 billion dollars a year.

* *

For serious collectors of stock market history, the book *Profits in the Stock Market* by Harold Gartley is now offered in a reprint from Lambert-Gann Publishing, PO Box 0, Pomeroy, WA 99347 (hard cover with separate portfolio of charts $90). Gartley, a famous technician of the 1930's, probably did more volume studies than any man alive. The book is a deep and heavy collection of Gartley's studies, and you could take months analyzing this rare volume (Gartley only printed 1000 copies of this work).

* *

We've all heard about Administration pressure on the Fed, which is calculated to bring interest rates down. But this is obviously a new wrinkle.

WASHINGTON (UPI) – A man threatened to take members of the Federal Reserve Board hostage yesterday because of the high cost of living and high interest rates but was arrested without any shots being fired, a city police spokesman said.

"He said he intended to take members of the Federal Reserve Board hostage and that he wanted publicity," the police spokesman said.

Besides a pistol, police said the man was armed with a sawed off shotgun.

* *

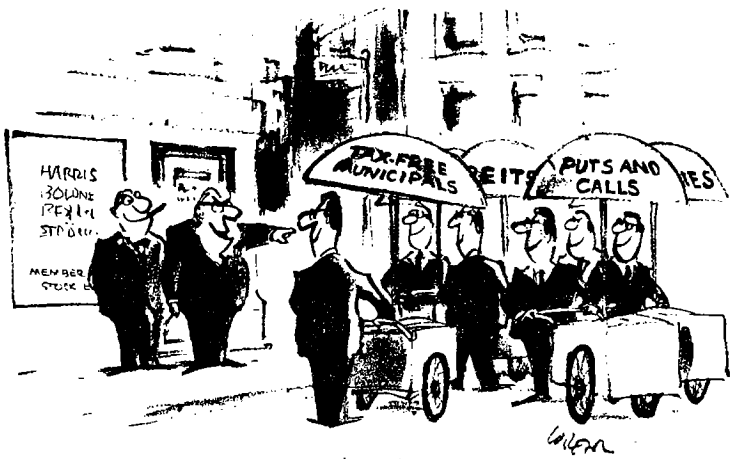
Open any magazine these days and you're liable to see a full page Smirnoff advertisement featuring none other than economist Eliot Janeway. Eliot may sip a bit of vodka for Smirnoff, but that has not dulled his razor mind. In proof, I offer this paragraph from the latest *Janeway Letter* (15 East 80th St., NYC 10021).

"The Bulge in Defense Appropriations: Of the $208 billion defense Appropriation Bill approved by the Senate, no less than $100 billion is being frittered away for payroll. The bloated condition of the Pentagon's payroll bill dramatizes the rate at which the US is going broke paying pensions to people going broke receiving them. The sorry state of the defense budget provides official confirmation of my warning that the Pentagon is still buying inflation without building muscle. The US is pitifully

lacking in the combat capability to carry out a single one of the missions (except for a strike at Libya!) Secretaries Haig and Weinberger are warning America's various adversaries to expect. As matters stand, the US government has landed in the worst of three worlds: spending much too much on defense to slow inflation, buying not nearly enough to spur recovery, and programming no weapons systems usable to meet any, much less all, of the military emergencies sizzling at peril points overseas."

* *

You can't tell a bank from a broker from a S & L from a conglomerate any more. Everybody wants to mess around with the other guy's business (maybe on "the grass looks greener" theory). Anyway, the *New Yorker* has a new wrinkle for Wall Street, and who knows, if things get rough enough maybe they'll try it!



"All right, men. Damn the torpedoes - full speed ahead!"

* *

Maybe Malcolm Forbes Jr. got a revelation while riding one of his big Harley motorcycles. It seems like only a few years ago that he was denigrating gold and all those who advocated a gold standard. But times change, and (to his credit), so does Malcolm. Forbes readers note page 29 of the current (Dec. 21) issue of *Forbes*, an article that ends: *"The trend is ominously clear. Without a return to gold, the economy is headed for increasingly difficult times."*

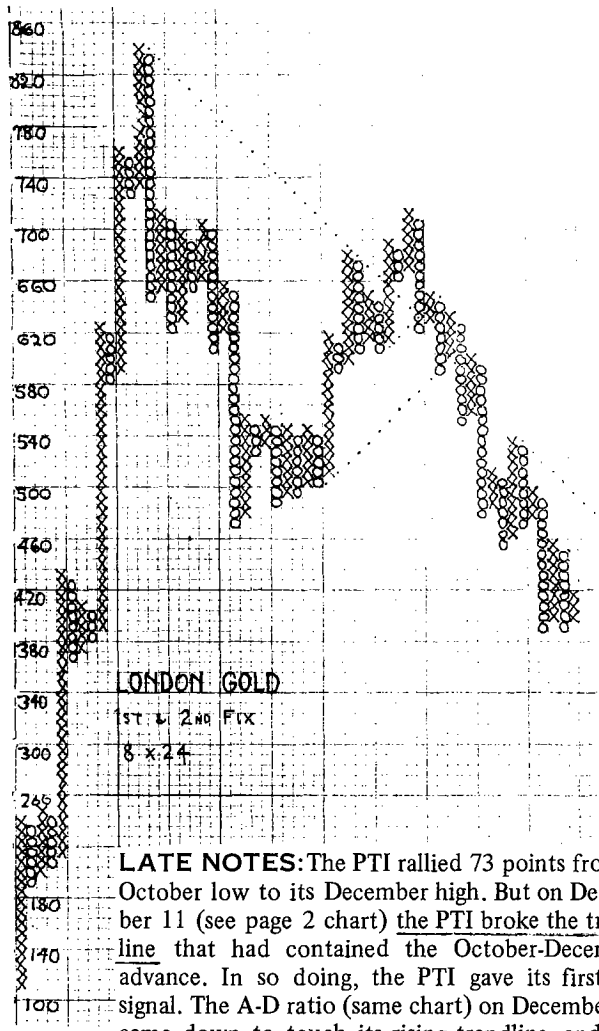
GOLD: Well, a lot of people have (and continue to) predict a final gold smash down to 350, 300, 250 or you name it. But gold keeps bouncing off the 400 level like a Mexican jumping bean popping off a hot sidewalk. This point & figure chart shows that gold is in a fairly large "congestion area" with a potential bear signal at 388 and a potential buy signal at 468.

Personally, I'm kind of impressed with gold's performance, particularly in the face of the sea of bearishness towards the metal. One factor that I've noticed over the years is that gold performs most profitably when my ratio of gold to the NYSE 400 (common stocks) is moving up in favor of gold. Conversely, gold is (at best) a question mark when the ratio is moving down in favor of common stocks. Right now the ratio is still in favor of common stocks, although I am getting hints of a possible change.

The moving averages for gold are also of great help in timing. On today's calculations the 5-week MA of gold is 413, the 13-week MA is 420 and the primary or 50-week MA is 461. Thus, spot London gold is still below even the 5-week MA. For a first indication of bullishness under this study, gold would have to climb above 413 and preferably above 420.

The biggest problem with owning more than "survival quantities" of gold continues to be the sacrifice brought on by loss of interest income. At today's juicy T-bill rate of near 11%, one receives 1/3 of this money back in just three years (I'm not figuring taxes). That's tough competition for anything–including gold.

By the way, the sensation of the big New Orleans Conference turned out to be a pamphlet on gold written by my friends, the Aden sisters of Costa Rica. The pamphlet (with many excellent charts) includes the Aden's astute predictions for gold now and in coming years. For serious gold students and investors, I recommend this pamphlet. It's $25 (US) and can be purchased at Adam Smith Publishing, 4425 W. Napoleon Ave., Metairie, LA 70001. The Adens are well qualified to prepare this study, having worked for many years for a brilliant and successful gold trader who is also one of our subscribers.



LATE NOTES: The PTI rallied 73 points from its October low to its December high. But on December 11 (see page 2 chart) the PTI broke the trendline that had contained the October-December advance. In so doing, the PTI gave its first sell signal. The A-D ratio (same chart) on December 11 came down to touch its rising trendline, and any further weakness will rupture this up-trend as well.

After the market closed the Fed announced a whopping $4 billion jump in M-1, and the bond markets staggered under the inflationary implications of this statistic. That the Fed is pumping away is the unquestioned fact. That the desired result will be obtained is far from certain. The money markets are very sophisticated today, and sharply rising money supply figures are taken (bearishly) as harbingers of inflation. Ironically, as the money supply rises countless billions of dollars are wiped out in bond (and mortgage) values!

NEXT MAILING: Dec. 30